COUNCIL AGENDA: 12-2-03
ITEM: 3.5

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: Honorable Mayor and Council

FROM: Kay Winer
Scott P. Johnson

SUBJECT: Hayes Mansion Management Agreement

DATE: November 24, 2003

Approved Del Borgsdorf Date 11-25-03

COUNCIL DISTRICT: City-Wide
SNI: N/A

RECOMMENDATION

Approval of a Management Agreement with Dolce International/San Jose, Inc. to operate the Hayes Mansion for ten years with two, five-year options, for a management fee of 3% of Gross Revenues, an Incentive Fee, and payment by City of the expenses of the operation, not covered by revenues.

BACKGROUND

On October 21, 2003, the Council adopted a resolution authorizing the City Manager to enter into exclusive negotiations for thirty days with Dolce International Holdings, Inc to negotiate a Management Agreement to operate the Hayes Mansion. Dolce International Holdings, Inc. has formed a subsidiary corporation Dolce International/San José, Inc. for the purpose of operating the Hayes Mansion.

Negotiations with Dolce have been completed. Major provisions of the Management Agreement are provided in the next section of this report. Included in the Agreement are provisions directed by Council action at the October 21 meeting for inclusion in the Agreement. They are: a Management Incentive Fee that would be paid to Dolce when certain financial thresholds are reached. Under this program, both parties would benefit because the City would have financial resources to retire the Comerica and Devcon loans at an earlier date. Secondly, the Environmental Preferable Procurement Policy would be included in the operations at the Hayes and finally, the City would engage an Asset Manager to act as the "Owner's Representative", providing advice on management, operational and financial matters at the Hayes Mansion.

Dolce has been working with Hayes Renaissance, LP ("HRLP") to assure a smooth transition of the operation. Discussions between Dolce and Local 19 are also proceeding well, as confirmed by both parties.

ANALYSIS

Major provisions of the Management Agreement are described below.

Term of Agreement

- Ten years commencing January 1, 2004 through June 30, 2014. (The additional six months is needed to effect a change from a calendar year to the City's fiscal year of July 1 through June 30.)
- Two, five-year options that can be exercised by Dolce at its option, on the condition that performance measures identified in the Agreement have been met for at least two of the three years immediately preceding the end of the original term or the extension period. The performance measures are that Dolce has met or exceeded at least 90% of the budgeted Gross Operating Profit [1] projected in the Annual Budget for the Hayes Mansion or 90% of the REVPAR [2] for the Hayes Mansion's Competitive Set. The current Competitive Set includes the Marriott, Fairmont, Crowne Plaza, Hyatt San Jose, Hyatt St Claire, Hilton San Jose & Towers, and Chaminade in Santa Cruz. The Competitive Set is subject to change from time to time based on the mutual agreement of the parties. The data source is Smith Travel Research, an independent research organization serving the lodging industry that provides performance measurements.
- In the event that the City sells the Hayes Mansion within the first ten year period of the Agreement, the sale must provide that Dolce International/San Jose, Inc. will be retained as the manager of the facility under the same terms and conditions. This means that Dolce could exercise the extension periods if it met the Agreement's requirements.
  In the event the City sells the Hayes Mansion during one of the extension periods, the City is not obligated to require the new owner to assume the Agreement. Instead, the City is obligated to pay Dolce the Termination Fee described below.

Dolce's Management Responsibilities

Under the proposed agreement, Dolce acts as the on-site manager of the Hayes Mansion in exchange for the Base Management Fee and Incentive Fee described below. Dolce will also provide routine maintenance and security for the parking garage in the adjacent Edenvale Garden Park and routine maintenance for certain park improvements. These tasks were previously the responsibility of HRLP as the tenant under the Hayes Mansion lease.

[1] Gross Operating Profit: Gross Revenues minus certain operating expenses.

[2] REVPAR: REVPAR is an industry measurement that determines whether the Hayes is receiving more or less of its market share of revenues.

The City will also be required to pay the operating expenses of the Hayes Mansion from the Hayes Mansion revenues or to the extent that these are not sufficient, from other City funds, including the Comerica Line of Credit. These operating expenses include all of the costs associated with operating the Hayes Mansion, such as wages and salaries, utilities, insurance, routine maintenance and food, beverage and merchandise sold at the Hayes Mansion. Dolce will also be reimbursed for various identified expenses related to marketing the Hayes Mansion, travel directly related to the operation of the Mansion, and booking fees and commissions for reservations made through Dolce's Central Reservation office or at other Dolce facilities.

Dolce Compensation

Base Management Fee

- For the first three months of the Agreement, the Base Management Fee will be $30,000 per month or 3% of Gross Revenues per month, whichever is greater. Thereafter, the Base Management Fee will be 3 % of Gross Revenues per month.
  Gross Revenues for purposes of calculating the Base Management Fee is defined as all revenues derived from the operation of the Hayes Mansion, including revenues from the sale of all conference services, rentals of facilities and guest rooms, sale of food, all beverages, charges for technology used in guest and meeting rooms, and revenues associated with fitness or recreation facilities and excluding taxes, insurance proceeds, and the gratuities actually paid to employees. Gross revenues do not include any funds that may be received in consideration for insurance claims or sale of furniture, fixtures and equipment.

Reduction of Base Management Fee If Performance Measures Are Not Met

For any year of the contract term commencing July 1, 2006 that performance measures are not met, the fee paid by the City to Dolce will be reduced by a percentage point for that year, i.e. the Base Management Fee will be reduced from 3% to 2% of Gross Revenues. This will be in the form of a credit to the City by reducing Management Fee payments payable by the City to Dolce in the subsequent year until the credit has been fully realized by the City. The performance to be achieved is at least 90% of budgeted Gross Operating Profit or 90% of the REVPAR Penetration Index for the Hayes' competitive set, as described previously in this report. I think this is where we define gross operating profit, not above.

Incentive Management Fee

Incentive management fees have been negotiated that provide financial incentives to Dolce for their management of the Hayes Mansion to generate net revenues from the operations of the Hayes Mansion to pay off the Devcon and Comerica loans approved in the Transition Agreement between the City and Hayes Renaissance Limited Partnership (HRLP). In addition, Dolce will be compensated in assisting the City in re-establishing the Phase III Market Rate Volatility Account (MRVA) to a level of $1.5 million. The MRVA was initially established to mitigate market risk on the City's variable rate debt. Funds from the MRVA were subsequently used to provide economic relief to HRLP. Once the interim debt for Hayes is paid off, this will provide reserves to mitigate the risk of fluctuations in short term variable interest rates.

Incentive fees for the initial 10-year agreement period are:

Threshold #1
25% of annual Net Revenues [Gross revenues less Hayes expenses, City debt service, principal and interest on Comerica Term Loan and interest on Comerica Revolving Loan]

Threshold #2
35% of Net Revenues after Threshold #1 is achieved AND Comerica Term Loan and Devcon Note are paid off.

Threshold #3
37% of Net Revenues after Threshold #1 and #2 is achieved AND the Comerica Revolving Line of Credit is paid off.

Threshold #4
40% of Net Revenues after Thresholds #1, #2 and #3 are achieved AND Phase III Market rate Volatility Account reaches a balance of $1.5 million.

Incentive Fees During Renewal Periods

The negotiated incentive fees to be paid to Dolce in the event of any renewal periods is 30% of Net Revenues after achieving Threshold #4. In the event that Threshold #4 is not achieved, the incentive fee is 25% of Net Revenues.

For illustrative purposes, Exhibit B is attached to show the method to be used in calculating Net Revenues and Incentive Fees. This illustrative example is based on Dolce's Ten-Year Proforma.

Base on Dolce's Ten-Year Proforma, Dolce projects that Net Revenues would be generated from the operations of the Hayes Mansion by year three (threshold #1 would be achieved). The Comerica Term Loan and the Devcon Note would be paid off by the end of year four (threshold #2 would be achieved). The Comerica Revolving Line of Credit would be paid off by the end of year seven (threshold #3 would be achieved). The MRVA would achieve a balance of $1.5 million in year 9 (threshold #4 would be achieved).

The Comerica Revolving Line of Credit should be retained until sufficient Hayes operating reserves are accumulated. Based on Dolce's proforma, the Comerica Revolving Line of Credit would be paid off in year seven from Net Revenues, which would require the City to negotiate an extension of the repayment date. However, staff recommends that the City maintain the Comerica Revolving Line of Credit as a means to fund any potential shortfall from operations to fund Hayes operating costs and the City's Hayes debt service costs until sufficient Hayes operating reserves are accumulated from the Hayes Net Revenues.

Key Business Terms and Conditions

Default and Termination

In the event that either party is in breach of a material term of this Agreement, the other party may terminate the Agreement after allowing the defaulting party to cure the breach within the specified cure period. In most instances, the cure period is 30 days.

However, commencing on July 1, 2006 and throughout the remaining term of the Agreement, if Dolce fails to attain at least 80% of the budgeted Gross Operating Profit or 80% of the REVPAR Penetration Index for the Competitive Set, the City may terminate the Agreement upon 3 business days notice.

If City elects to terminate the Agreement for any reason other than certain specified events, including breach by Dolce or Dolce's failure to meet the performance measure described above, the City will be required to pay to Dolce a termination fee calculated as follows:

- For the first two years of the Agreement, the termination fee is the greater of two times the Base and Incentive Management Fees earned by Dolce in the 12 months preceding the termination date or $250,000.
- Beginning in year 3 of the ten-year agreement and any years of the two five-year options, the termination fee is the lesser of the Base and Incentive Management Fees earned by Dolce in the 12 months preceding the termination date or $800,000.

Damage and Destruction/Condemnation

In the event that the Hayes Mansion is totally destroyed or is condemned, then the Agreement will terminate. If the Hayes Mansion is partially destroyed or partially taken by a governmental entity and the proceeds of the insurance or the taking are insufficient in the City's judgment to rebuild, the Agreement will also terminate. If the Agreement terminates during the initial term of the Agreement, the City is obligated to pay to Dolce the termination fee described above. If the Agreement terminates during an option period, then City is obligated to pay the actual cost of relocation of Dolce's Strategic Team located at the Hayes Mansion with a cap of $200,000.

Insurance and Indemnity

Under the Agreement, Dolce is required to provide various types of insurance coverage, including general liability, workers' compensation, auto and employment practices liability. The City will be named as an additional insured for each of the required policies.

The City and Dolce each agree to indemnify the other, to the extent a loss or claim is not covered by insurance, for its acts or omissions. In addition, the City agrees to indemnify Dolce for any Operating Expense incurred by Dolce in accordance with the terms of the Agreement.

Wage Policies

Dolce will abide by the City's adopted Wage Requirements, including Worker Retention and Labor Peace. With respect to Labor Peace, Dolce has committed to abide by the terms of its agreement with Local 19 which includes a grievance procedure. Although Dolce anticipates operating the facility under a bargaining agreement with Local 19, the Agreement provides that, absent a bargaining agreement during its term of Agreement, the living wage will be applied.

Hayes Mansion Assets

The transition agreement with HRLP provides that HRLP transfers ownership of all Hayes assets owned by HRLP to the City. The agreement with Dolce does not provide for the transfer of ownership of any Hayes assets to Dolce with once exception. HRLP owns five vehicles that are used in the operation of the Hayes Mansion. In order for the vehicles to be covered under Dolce's automobile insurance policy, title to these vehicles will be transferred from HRLP to Dolce. Upon iteration of the Agreement, or the end of the useful life of these vehicles, Dolce is obligated to transfer the vehicles to the City.

Budget Process

Transition Budget

A transition budget has been submitted by Dolce that includes certain travel, relocation, technology, and costs for preparation of collateral and marketing materials specific to the Hayes Mansion. The total expenses are not to exceed $177,500 and expenses will be submitted with the reimbursement requests to the City and payable as operating expenses of the Hayes Mansion.

Annual Operating Budget

Dolce is responsible for preparing the Annual Budget for the Hayes Mansion for a July 1 to June 30 Fiscal Year. Dolce will prepare the proposed annual budget with appropriate diligence and give due consideration to all relevant factors affecting the operation of the Center, including without limitation, market and economic conditions. Accompanying the proposed budget will be supporting reports, including: sales and marketing; human resource, technology, cash flow forecasts by month for the fiscal year; and a summary income statement. The proposed budget will also include an estimated profit and loss statement in the format recommended by the International Association of Conference Center Uniform System of Accounts and Dolce's projected Gross Operating Profit for the ensuing Fiscal Year.

In the event that the City and Dolce do not reach agreement on the proposed Annual Budget, any of the following could occur:

- Dolce may refuse to operate the Hayes Mansion and may terminate the Agreement;;
- Dolce may terminate the Agreement on 90 days notice; or

- Dolce may agree to operate Hayes Mansion based on the Annual Budget desired by the City.

As the Agreement will commence during the middle of the 2003-04 Fiscal Year, Dolce is not obligated to provide the detailed Annual Budget. Instead, no later than forty-five days following the execution of Agreement Dolce is obligated to prepare for City's review and approval, a six month cash flow projection through June 30, 2004.

Proposed Capital Improvements

Dolce shall submit, on or before January 15 of each year, a proposed list of Capital Improvements which are recommended to be undertaken during the ensuing five-year period. The recommended expenditures will be submitted in priority order, including the estimated costs for design, materials, construction, and the proposed contingency for each identified Capital Improvement. A Facilities Reserve Fund equal to 4% of Gross Revenues for the previous calendar month is established to be utilized exclusively to fund the costs of repair or for capital improvements that exceed $5,000, and the costs for replacement of capital improvements on or at the Hayes Mansion. Dolce recognizes and agrees, however, that should the Reserve Fund be inadequate to fund any or all of the Capital Improvement Program submitted for the Hayes Mansion, these improvements will be evaluated against the needs for capital improvements in all of the City's other facilities and properties.

City Oversight

Asset Manager

Dolce agrees to cooperate with the Asset Manager selected by the City. HVS International, Inc., the City's current hospitality consultant, will be engaged to provide these services for the upcoming year. The Asset Manager will advise the City on management, operational and financial performance matters. The Agreement specifies that the amount of the contract for these services is for an amount not to exceed $50,000 per year with an annual CPI adjustment. This is a type of operating expense that is not subtracted from Gross Revenues in order to arrive at Gross Operating Profit.

City Review of Books and Records

Dolce shall submit to the City within fifteen days after the end of each calendar month, and may be requested to attend meetings with the Finance Department. Among the reports to be submitted are:

- An unaudited financial statement containing a statement of current assets and current liabilities; a profit and loss statement, including the Gross Revenues for each calendar month and cumulatively, including budget vs. actual.
- Actual and forecasted Cash flow and profit and loss by month for the balance of the fiscal year.

- Capital expenditure report.
- Detailed Sales backlog.
- Variety of financial and accounting reports.
- Any other reports as reasonably requested by the City's Director of Finance

An audit of the books and records of the Hayes Mansion shall be performed by an independent certified public accounting firm acceptable to the City to be completed with a report submitted to the City within 180 days after the end of the fiscal year.

Approval of General Manager

City will have the right to approve Dolce's approval of the initial selection and any change in or transfer of the General Manager assigned to the Hayes Mansion.

Corporate Marketing and Sales Programs and Services

- The services and programs to be implemented will include those provided by Dolce's Corporate Marketing department that functions as an in-house agency providing creative and execution services for advertising, collateral materials, web site development and maintenance, direct mail, public relations, trade shows and promotional events.
- The Corporate Marketing Department will provide strategic marketing direction and support for the Hayes Mansion by positioning the facility in the marketplace; develop strategies to execute the annual Sales and Marketing plan prepared as part of the annual budget process.
- The Hayes Mansion will be positioned under the Dolce International brand; Dolce agrees to incorporate the Hayes Mansion in all corporate marketing activities which present the portfolio of Dolce-managed properties.
- Hayes Mansion will be included in the Dolce International Global Account Program. This proprietary program represents the principal corporate customers of Dolce Internal who conduct significant levels of meetings at multiple Dolce-managed properties.

Standards of Operation and Maintenance

The Hayes Mansion will be operated by Dolce as a first class conference center, consistent with International Association of Conference Center (IACC) standards. Unless approved by City, Dolce shall operate the Hayes Mansion twenty four hours a day, seven days a week.

PUBLIC OUTREACH

Not applicable.

COORDINATION

This report was prepared jointly by the City Manager's Office, Finance Department and the City Attorney's Office.

CEQA

Not a project.

Kay Winer
Deputy City Manager

Scott P. Johnson
Director of Finance

Dolce International | Hayes Mansion | (for Illustrative Purposes Only) | **Exhibit B**

Proforma Hayes Mansion Rooms 214
Currency: USD
25-Nov-03

	Year # 1	Year # 2	Year # 3	Year # 4	Year # 5	Year # 6	Year # 7	Year # 8	Year # 9	Year # 10
REVENUE										
Rooms	4,588,000	6,016,000	7,309,000	8,202,000	8,694,000	8,954,820	9,223,465	9,500,169	9,785,174	10,078,729
Food {& Bev 2003}	4,408,000	5,547,000	6,417,000	6,925,000	7,250,000	7,467,500	7,691,525	7,922,271	8,159,939	8,404,737
Beverage	823,000	1,150,000	1,467,000	1,514,000	1,575,000	1,622,250	1,670,918	1,721,045	1,772,676	1,825,857
Conference Services	1,980,000	2,513,000	2,953,000	3,185,000	3,333,000	3,432,990	3,535,980	3,642,059	3,751,321	3,863,860
Spa	300,000	414,000	518,000	631,000	736,000	758,080	780,822	804,247	828,374	853,226
Minor Operations	371,000	568,000	678,000	744,000	770,000	793,100	816,893	841,400	866,642	892,641
TOTAL REVENUE	12,470,000	16,208,000	19,342,000	21,201,000	22,358,000	23,028,740	23,719,602	24,431,190	25,164,126	25,919,050
DIRECT EXPENSES										
Rooms	1,244,000	1,431,000	1,600,000	1,715,000	1,774,000	1,827,220	1,882,037	1,938,498	1,996,653	2,056,552
Food & Beverage	3,560,000	4,413,000	5,073,000	5,419,000	5,646,000	5,815,380	5,989,841	6,169,537	6,354,623	6,545,261
Conference Services	811,000	1,010,000	1,118,000	1,183,000	1,228,000	1,264,840	1,302,785	1,341,869	1,382,125	1,423,589
Spa	270,000	352,000	414,000	473,000	515,000	530,450	546,364	562,754	579,637	597,026
Minor Operations	213,000	326,000	389,000	427,000	442,000	455,260	468,918	482,985	497,475	512,399
TOTAL DIRECT EXPENSES	6,098,000	7,532,000	8,594,000	9,217,000	9,605,000	9,893,150	10,189,945	10,495,643	10,810,512	11,134,827
Gross Operating Income	6,372,000	8,676,000	10,748,000	11,984,000	12,753,000	13,135,590	13,529,658	13,935,547	14,353,614	14,784,222
INDIRECT EXPENSES										
Engineering	634,000	658,000	681,000	703,000	722,000	741,855	762,256	783,218	804,757	826,887
Sales and Marketing [1]	1,406,000	1,409,000	1,483,000	1,541,000	1,585,000	1,628,588	1,673,374	1,719,391	1,766,675	1,815,258
Administrative and General	1,327,000	1,402,000	1,474,000	1,530,000	1,577,000	1,620,368	1,664,928	1,710,713	1,757,758	1,806,096
Base Mgt Fee	374,000	486,000	580,000	636,000	671,000	691,000	712,000	733,000	755,000	778,000
Utilities	668,000	808,000	928,000	996,000	1,020,000	1,048,050	1,076,871	1,106,485	1,136,914	1,168,179
TOTAL INDIRECT	4,409,000	4,763,000	5,146,000	5,406,000	5,575,000	5,729,860	5,889,429	6,052,808	6,221,103	6,394,420
Gross Operating Profit	1,963,000	3,913,000	5,602,000	6,578,000	7,178,000	7,405,730	7,640,229	7,882,739	8,132,511	8,389,802
FIXED EXPENSES										
Insurance	191,000	249,000	297,000	325,000	343,000	343,001	343,002	343,003	343,004	343,005
Property Taxes	292,000	299,000	306,000	313,000	321,000	321,001	321,002	321,003	321,004	321,005
Asset Mgr Fee	50,000	51,250	52,531	53,845	55,191	56,570	57,985	59,434	60,920	62,443
Lease & Oth	261,000	267,000	274,000	280,000	287,000	294,893	303,002	311,335	319,896	328,693
TOTAL FIXED EXPENSES	794,000	866,250	929,531	971,845	1,006,191	1,015,465	1,024,991	1,034,775	1,044,825	1,055,147
Net Operating Income	1,169,000	3,046,750	4,672,469	5,606,155	6,171,809	6,390,265	6,615,238	6,847,964	7,087,687	7,334,655
OTHER EXPENSES										
Furniture, Fixt. & Equip.	499,000	648,000	774,000	848,000	894,000	921,150	948,784	977,248	1,006,565	1,036,762
HayesDebt Service	1,950,000	2,400,000	2,600,000	3,400,000	4,050,000	4,050,000	4,050,000	4,050,000	4,050,000	4,050,000
Comerica term loan pmts	549,000	535,000	521,000	507,000						
Comerica line interest pmts	35,000	74,000	83,000	83,000	78,000	55,000	31,000			
TOTAL OTHER EXPENSES	3,033,000	3,657,000	3,978,000	4,838,000	5,022,000	5,026,150	5,029,784	5,027,248	5,056,565	5,086,762
NET REVENUE	(1,864,000)	(610,250)	694,469	768,155	1,149,809	1,364,115	1,585,454	1,820,717	2,031,121	2,247,893
Incentive Management Fee			173,617	192,039	402,433	477,440	554,909	673,665	812,449	899,157